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SUBJECT: EU Commission Forecasts Significant Worsening in EU Economy

1. (SBU) Summary: The European Commission released on January 19 its interim economic forecasts, advancing their release date by a full month due to the exceptionally difficult economic circumstances. The forecasts recognize that the impact on the real economy became more pronounced after the events evolved extremely rapidly in the financial markets last year. Europe entered the recession in the third quarter of 2008. The recession is expected to continue, with a further decline of GDP in the first two quarters of 2009, as confidence indicators plunged to record lows in December.

Financial crisis is being passed on to the real economy

2. (SBU) The most recent economic forecasts by the European Commission expect GDP to fall sharply (-1.8 pct. in the EU and -1.9 pct. in the euro area) in 2009, before recovering by about 0.5 pct. in 2010. Estimated figures for 2008 put GDP growth at about 1 pct., down from 3 pct. in 2007. As a result of the slowdown, unemployment figures are expected to rise to 8.7 pct. in the EU in 2009 (and 9.2 pct. in the euro area), with a further increase in 2010, and deficits will also grow in 2009 - from 2 pct. to 4.5 pct. in the EU and from some 1.7 pct. to 4 pct. in the euro area. Inflation, on the other hand, is set to fall rapidly, from 3.7 pct. in 2008 in the EU (3.3 pct. in the euro area) to 1.2 pct. in 2009 (1.0 pct. in the euro area) and just below 2 pct. in 2010 in both regions. Global growth is also expected to slow to 0.5 pct. in 2009 from 3.3 pct. in 2008, before starting a moderate recovery during the second half of 2009, reaching an expected 2.7 pct. in 2010., the Commission decided to advance by more than one month its interim forecasts.

Investment slows more markedly than demand

3. (SBU) The current recession is broad-based and affects all demand components except government consumption and public investment. Disposable income growth is expected to be adversely impacted by higher unemployment and lower wage growth in 2009. In addition, concerns about the outlook for the economy could prompt households to remain cautious, in spite of lower inflation and considerable efforts by governments. Private consumption is therefore expected to contract slightly in 2009, and to regain some ground only in 2010. Private investment, on the other hand, is severely affected by the economic downswing in general, as well as by the ongoing housing crises in some economies. Housing investment in the euro area is set to fall by about 9 pct. in 2009 and to continue shrinking, albeit at a smaller rate, in 2010. A similar pattern is expected for investment in machinery and equipment, on the back of the current fall in capacity utilization rates and the worsening of the outlook for 2009 along with a slight further decline in 2010. This also reflects tighter credit conditions despite considerable efforts by government and central banks.

Deficit and debt are on the rise

4. (SBU) The economic downturn is having a significant negative impact on public finances over the forecast horizon. In 2008, the budget deficit in the EU stood at 2.0 pct. of GDP, up from 0.9 pct. in 2007. Similarly, in the euro area the deficit rose from 0.6 pct. of GDP in 2007 to 1.7 pct. in 2008. A further worsening of fiscal balances is foreseen for 2009 and 2010. In 2009, the deficit in the EU is projected to rise sharply (+2.5 percentage points) to 4.5 pct. of GDP. In the euro area, the deficit is projected to reach 4 pct.

of GDP. In both areas, this would represent the highest general government deficit in almost fifteen years. A further increase by almost 0.5 percentage points is foreseen for 2010 in both regions, leading to deficits of just below 5 and 4.5 pct. of GDP in the EU and the euro area, respectively.

¶15. (SBU) In the euro area, the budget deficit is set to breach the 3 pct.-of-GDP reference value in Ireland, Greece, Spain, France, Italy, Portugal and Slovenia in 2009, with Ireland experiencing a particularly sharp deterioration.

¶16. (SBU) Outside the euro area, government balances are also forecast to see a broad-based deterioration. The downturn, combined with expansionary discretionary measures, is projected to widen the deficit in the United Kingdom by more than 4 pct. to 8.7 pct. of GDP in 2009.

Unemployment rising

¶17. (SBU) After favorable developments during 2005-2007, the labor market started to weaken in most Member States in the course of ¶2008. In the third quarter of 2008, employment in the euro area declined by 0.1 pct. from the previous quarter, while it stagnated in the EU. The unemployment rate stood at 7.8 pct. in the euro area and at 7.2 pct. in the EU in November 2008, up by about 0.5 percentage points from early 2008 levels. The labor market situation is forecast to deteriorate markedly as companies react increasingly to reduced demand and tighter financing conditions. Employment is expected to contract by more than 1.5 pct. in both the euro area and in the EU in 2009. The pace of decline is expected to slow in 2010, with employment contracting by around 0.5 pct. in both areas. As a result, the unemployment rate is forecast to increase by close to 3 percentage points from the lows of early 2008, averaging 10.2 pct. in 2010 in the euro area and 9.5 pct. in the EU.

Inflation falling

¶18. (SBU) The recent fall in commodity prices and inflation, which should lend support to real household disposable income and cushion the fall in household consumption, is one of the few positive data points. Euro-area inflation has remained above 3 pct. until October 2008, peaked in June - July at 4 pct., and has been more than halved, reaching 1.6 pct., in December. Looking forward, inflation in the euro area is now expected to come down rapidly and bottom out at 0.5 pct. in the third quarter of 2009. By end-2009, inflation is set to rebound to 2 pct. and stabilize thereafter at 1.7 pct.. The reasons are to be found particularly in the further and substantial worsening of the economic outlook for both the euro area and the global economy. This is already putting substantial downward pressure on commodity prices and should also curb wage growth.

¶19. (SBU) The economic situation and outlook for the EU are unprecedentedly uncertain. While many of the downside risks to the growth outlook that were identified in the autumn forecasts have begun to materialize, leading to the significant downward revision in the current baseline projection. However, with the pronounced deterioration in growth prospects compared with the autumn and taking into account the various rescue and recovery packages, the Commission's forecasts considers the risks to the growth and inflation outlook to be broadly balanced at the current juncture.

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